Internal Revenue Service

memorandum

CC:INTL-0269-91
Br1:WEWilliams

date: APR 17 1991

to: District Counsel
Louisville

from: Chief, Branch No. 1
Associate Chief Counsel (International) CC:INTL:1

subject: [redacted]

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This responds to your memorandum dated March 15, 1991, in which you request our advice on one of the issues in this case. Your memorandum describes two issues involved in [redacted] purchase of a [redacted] in Ohio from an unrelated company, [redacted]. One of the issues involves I.R.C. § 483; the other issue involves section 482. You request our views with respect to the latter issue.

Facts:

The issue involves transactions between certain subsidiaries of [redacted], a U.K. corporation. The corporate structure as relevant to the issue under consideration is as follows:

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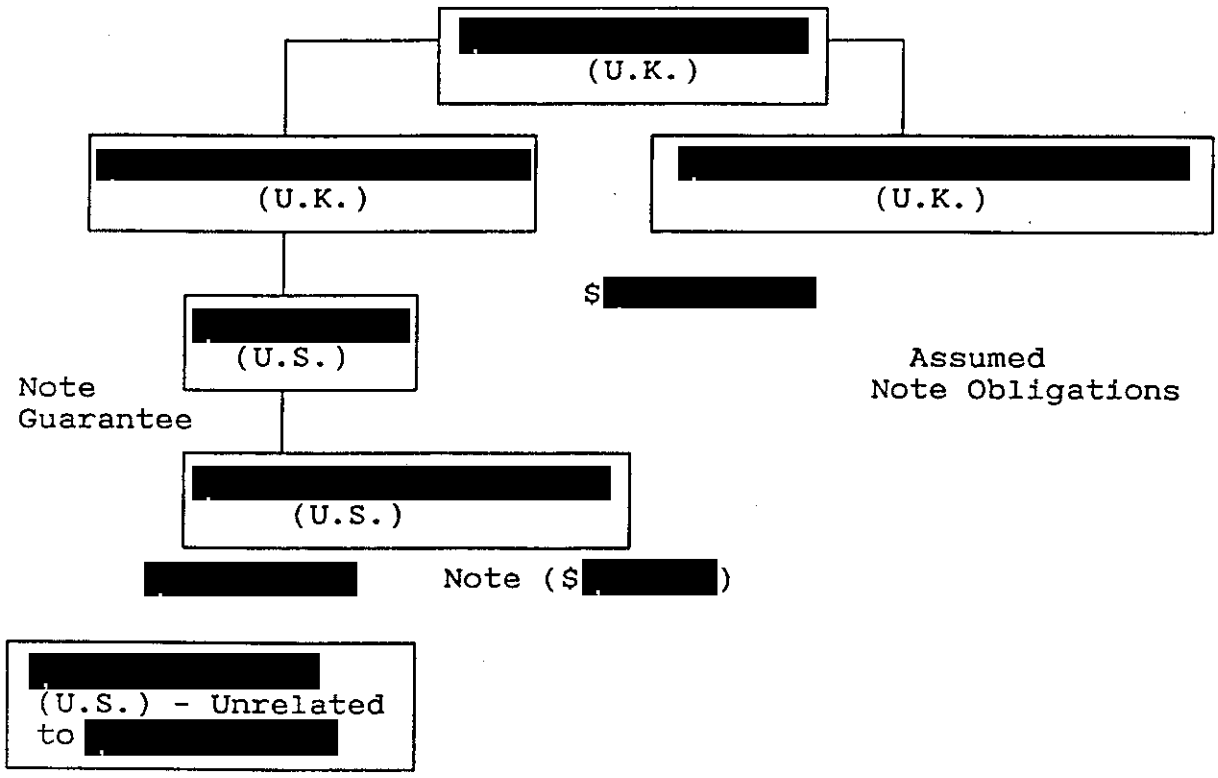

is a second tier U.S. subsidiary of (U.K.). In , purchased a paper mill from , an unrelated third-party. The purchase price was $. The consideration paid by in consisted solely of a promissory note to in the face amount of $, representing the purchase price plus interest at per annum of $. The note was payable in . note was guaranteed by , the former's parent and a first tier subsidiary of . As further security for , purchased a letter of credit from to secure payment of the promissory note.[1]/ Under the letter of credit, agreed to reimburse for any amounts that the bank paid out under the letter of credit. As a result of this agreement, a number of restrictions were placed on , and taxpayer explored ways of removing this potential liability from its books.

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[1]/ reimbursed for the price of the letter of credit.

On [redacted], [redacted] removed from its books its potential liability under the [redacted] note in the following way: The present value of the note for $[redacted] was calculated as $[redacted] transferred $[redacted] to [redacted], a U.K. first tier subsidiary of [redacted], in consideration for the latter's agreement to pay the $[redacted] note in full on its maturity date in [redacted]. [redacted] also agreed to reimburse [redacted] for any amounts that [redacted] was required to pay in connection with its guarantee of the note that [redacted] gave to [redacted]; [redacted] also assumed [redacted] obligations under the letter of credit. In fact, [redacted] was never advised of any of these transactions, and there is some question whether the assumptions by [redacted] would permit [redacted] to require payment by [redacted].

From the date it received the $[redacted] from [redacted] until it paid the note on [redacted], [redacted] earned approximately $[redacted] in income from investments of the $[redacted].

As your memorandum to us indicates, the primary issue in this case involves the loss deduction claimed by [redacted] in [redacted] as a result of the payment of $[redacted] to [redacted]. The loss deduction claimed by [redacted] on its apparent consolidated federal return filed with [redacted] $[redacted], was computed by [redacted] as the difference between a claimed basis in the assets acquired from [redacted] ($[redacted]) and the amount paid to [redacted] ($[redacted]). You have not specifically asked us for our views on this issue.

As to the section 482 issue, you have concluded that [redacted] transfer of the $[redacted] to [redacted] was not in substance a satisfaction of a future liability but was rather an advance/loan of funds to a related entity. You point out that if the funds had not been transferred to [redacted], they would have been available for investment by [redacted]. However, the income that would have been earned by [redacted] would have been subject to the U.S. tax rate which was higher than the rate imposed by the U.K. on the income earned by [redacted]. The income would also have been subject to U.K. tax when received as dividends by [redacted]. You also point out that if the funds had not been transferred to [redacted], they could have been used by [redacted] to reduce its debt on which it was paying a fair market interest rate. You request our comments on the proposed loan recharacterization of

the transfer of the $[redacted] to [redacted] and on a section 482 allocation of interest income to [redacted].

Discussion:

I.R.C. § 482 authorizes the Secretary of the Treasury to allocate income, deductions, credits, or allowances between controlled entities if he determines that such an allocation is necessary to prevent evasion of taxes or clearly to reflect the true income of the controlled enterprises. The purpose of section 482 is to prevent the artificial shifting of the true net incomes of controlled taxpayers by placing controlled taxpayers on a parity with uncontrolled, unrelated taxpayers. Commissioner v. First Security Bank, 405 U.S. 394, 400 (1972). The Secretary's authority under section 482 is broad (see, e.g., PPG Industries v. Commissioner, 55 T.C., 928, 990-991 (1970)), and an allocation must be sustained absent a showing that the Secretary has abused his discretion. Paccar, Inc. v. Commissioner, 85 T.C. 754, 787 (1985), aff'd 849 F.2d 393 (9th Cir. 1988).

Section 1.482-1(b)(1) of the Treasury Regulations describes the scope and purpose of section 482 as follows:

> The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

Section 482 does not, however, authorize the IRS to recast transactions in a different form than that utilized by the controlled taxpayers (assuming the form of the transaction is the

same as its substance); rather, under section 482, the IRS adjusts taxable incomes to reflect the result that would have determined under the same transaction if it had been between unrelated parties at arm's length. As the Supreme Court noted in Commissioner v. First Security Bank of Utah, supra, footnote 4,

> [t]axpayers are ... generally free to structure their business affairs as they consider to be in their best interests, including lawful structuring ... to minimize taxes.

In Eli Lilly & Co. v. Commissioner, 84 T.C. 996, 1126 (1985), aff'd in part, rev'd in part, and remanded 856 F.2d 855 (7th Cir. 1988), the Tax Court rejected a perceived IRS argument that "because petitioner could have retained the ownership of the patents and know-how and realized all the income attributable thereto, petitioner's transfer of the ownership of the patents and know-how can be ignored for income tax purposes." Similarly, in Seminole Flavor Co. v. Commissioner, 4 T.C. 1215, 1235 (1945), the Tax Court stated as follows:

> Actually, the principal force behind all of the Commissioner's arguments is that the petitioner could as well have done all the things that the partnership did and reaped all of the earnings of the related enterprises. Since petitioner could have had the earnings, the Commissioner would make it so by exercising the authority conferred by [the predecessor of section 482]. The same argument was made in the Koppers case ..., which rejected the argument in language equally apt to the present contention ....
>
> "The answer to this argument is that petitioner did not do this. It was free to and did use its funds for its own purposes. It was under no obligation to so arrange its affairs and those of its subsidiary as to result in a maximum tax burden."

With respect to the case under consideration, there may be doubt that there was a valid assumption by and shifting of legal liability to [redacted] of the debt owed by [redacted]. In this regard, [redacted] was never notified of the transactions between [redacted] and [redacted] and, therefore, never consented to substitution of [redacted] for either [redacted] or [redacted].

However, it is quite possible that as between [redacted] on the one hand, and [redacted] and [redacted]

[redacted] on the other hand, the former assumed all of the responsibilities and obligations of the latter on the note to [redacted]. We are aware of no legal reason that a debtor cannot sell a note/debt or a future obligation to pay. Furthermore, the transactions were reflected in written agreements between the parties, including one dated [redacted], that included the following:

> In consideration of [redacted]'s [redacted] payment to [redacted] in the amount of US$[redacted], receipt of which is hereby acknowledged by [redacted]:
>
> 1. hereby assumes [redacted]'s obligation to pay the Note in full at its maturity, and
>
> 2. agrees to assume [redacted] obligations contained in Section 2.2 of the Purchase Agreement with respect to the execution and delivery of a reimbursement or indemnity agreement as may be required by a Substitute Bank ..., and
>
> 3. will also reimburse [redacted] in full for any amounts which [redacted] is required to pay to [redacted] as a result of [redacted]'s failure to pay the Note in full in accordance with its terms.

It is our view that the question here is whether [redacted] paid an arm's length rate for [redacted]'s agreement to assume their obligations on the note to [redacted] and under the letter of credit. Since this is factual and related to the section 483 issue, we are unable to make any determination in this regard.

On the facts presently available, we do not believe that the IRS could defend the positions that the $[redacted] that [redacted] paid to [redacted] was in fact a loan and that the Service may allocate interest income from [redacted] to [redacted] under the authority of section 482. In this regard, the necessary documents seem to be in existence to support taxpayers' argument that [redacted] became obligated to them for their liabilities under the promissory note and letter of credit. However, these are factual questions, and we cannot determine on the facts available to us whether the debt to [redacted] was properly represented as principal of $[redacted] and interest of $[redacted] (or whether the mix of principal and interest should be different), whether [redacted] incurred a gain or loss on the purported sale of the obligation to [redacted], or whether the fair market value of the obligation was $[redacted] as reported by taxpayers.

If you have any questions on our views on the section 482 issue, please call Ed Williams at FTS 287-4851.

GEORGE M. SELLINGER